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Results Conference Call Transcript

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In October 2015, the European Securities Markets Authority (ESMA) published guidelines on Alternative Performance Measures (APM), applicable to regulated information published from July 3, 2016. Information related to APM used in this presentation are included in our condensed consolidated interim financial statements and consolidated interim management report for the six-month period ended Jun 30, 2018 submitted to the Spanish National Securities Market Commission (CNMV), in Note 2, page 9 of the .pdf filed. Recipients of this document are invited to read it.

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Introduction

Pablo Eguirón – *Global Director of Investor Relations*

Good morning, and welcome to Telefónica's conference call to discuss January-June 2018 results. I am Pablo Eguirón, Global Director of Investor Relations.

Before proceeding, let me mention that financial information contained in this document related to the second quarter 2018 has been prepared under international financial reporting standards, as adopted by the European Union. From the first of January 2018 we implemented IFRS 15 & 9, and all financial information in this presentation is based on this new standard. In organic terms, the effects of the accounting change to IFRS 15 are excluded in 2018. This financial information is unaudited.

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We encourage you to review our publicly available disclosure documents filed with the relevant securities market regulators. If you don't have a copy of the relevant press release and the slides, please contact Telefónica's Investor Relations team in Madrid or in London. Now let me turn the call over to our Chairman and Chief Executive Officer, Mr. José María Álvarez-Pallete.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Q2 Highlights |Continued progress with strategic priorities

Thank you, Pablo. Good morning and welcome to Telefónica's second quarter results conference call. With me today are Angel Vilá, Chief Operating Officer and Laura Abasolo, Chief Financial and Control Officer, and during the Q&A session you will have the opportunity to address us with any questions you may have.

I am pleased to present solid second quarter results, which showed continued progress on our strategic goals set for the year, responding today to the needs of the future.

Business sustainability leverages on the robust momentum seen in high-value connections. LTE accesses increase 31% with LTE coverage reaching 73%, whilst UBB connections increase 23%, having passed more than 47 million premises. In addition, bundling and upselling remains an ultimate lever to increase revenue per access and reduce churn.

By markets, we highlight the stronger franchise in Spain after recent content acquisition and the O2 brand launch, market leading position in key segments in Brazil, the improving trends in the UK, the positive impact of new tariffs in Germany, healthy growth in South Hispam and good commercial traction in North Hispam.

Optimising our capabilities is a must and we are radically transforming networks. We have created a global digital ecosystem centered around the customer and we are forefront runners in cognitive intelligence. Digitalization is driving business strategies and is starting to generate efficiencies.

So, all in all, we report strong delivery in financials, consistent with the full year outlook, with acceleration in growth trends of key metrics and net debt declining for the 5th consecutive quarter, even after dividend payment of 20 euros cents per share in cash.

Financial achievements

To review our latest financial achievements, please turn to slide number 3.

Reported figures were affected in the second quarter by non-recurrent impacts amounting to +225 million euros in OIBDA and -60 million euros in net income, namely derived from a Brazilian Court Ruling and Mexico impairment and tax assets reversal. Forex and negative effect from regulation across Europe and Latam also dragged growth.

In organic terms, we posted sustained organic revenue, OIBDA and OpCF growth, with margin progression. Revenues surpassed 12.1 billion euros, 2% more vs. last year, OIBDA 4.2 billion euros, +4.1% year-on-year, and OpCF reached almost 2.4 billion euros, +0.3% from the previous year.

Net income increased to 900 million euros in the second quarter, +9.9% year-on year and net financial debt decreased 10.1% in the last twelve months, leveraged on a Q2 18 FCF ex spectrum 1.5 times higher that of the same period last year.

Guidance confirmed

Let's move now to the guidance on slide 4.

We are well on track to deliver our full year guidance across all three metrics.

Regarding our dividend, we paid the second tranche of 2017 dividend of 0.2 euros per share in cash on of 15th June. In addition, we confirm the 0.4 euros per share in cash for 2018.

Finally, we continue deleveraging and working to improve ROCE.

Continued Revenue, OIBDA and OpCF increase

Let's move now to slide 5.

During the second quarter we posted healthy year-on-year growth rates across the board, improving sequentially in organic terms; +10 basis points in Revenue, 90 in OIBDA and 25 in margin terms. Operating Cash Flow is decelerating due to Capex phasing, but growing in the first six months by 2.4% year-on-year.

Organic Service Revenues maintained trends vs what seen in Q1, and OpEx improved on our continued focus on cost control and efficiency measures, digitalisation and synergies from integration. To highlight, all regions are contributing positively to OIBDA increase year-on-year in Q2, but North Hispam, which is impacted by regulation.

A platform Company| Advancing towards a Digital Telco

As shown on slide 6, we are a platform Company advancing towards a Digital Telco, by leveraging both on a customer centric digitalization and on the use of artificial intelligence across all platforms.

Our first platform consists of larger, smarter and more efficient networks. We are number one in virtualization, with our global solution "UNICA" under industrialization process and available in 4 countries; we count on 78 million premises passed with UBB and our LTE coverage ranges from 92% in Europe to 67% in Latam. We have, as well, installed more than 3 million customer devices of "Home Gateway Units" that incorporate the latest features at a lower price.

Systems & IT transformation on our second platform showed solid progress, as such our E2E index reached 62%, growing 8 percentage points year-on-year, the same growth rate of customers migrated to Full Stack in the period.

On our third platform, we are bringing digitalization to customers at a global scale. Our revenue mix is transforming and up to June 53% of our total sales are coming from Connectivity and Services Beyond Connectivity.

Lastly, benefiting from the capabilities of our fourth platform and aiming to enrich customer experience, since the 3rd of July it is possible to access to Aura through Movistar Home in a pilot service in 6 shops in Spain, before the commercial launch anticipated within the coming months.

Data monetisation | Capturing the added value of connectivity

Now, let me review the main guidelines of our monetisation strategy in slide 7.

In the customer segment, we are adding new levers to our portfolio, promoting upselling and increasing the customer lifetime value.

In prepaid, integrated recurrent data plans are present in 43% of Latam customer base, and 62% in Brazil, delivering ARPU uplifts of around 10%. In postpay, we enlarged data allowances with dedicated data tariffs or family plans, and we bundle video to encourage usage and increase customer loyalty. In fixed, video and UBB continue to be the main growth drivers.

In the B2B market, we leverage on our differentiated capabilities being the best partner for our customers' digital transformation. Our global capillarity and a complete portfolio of owned leading brands and partnerships allowed us to deliver strong results, with Cloud and Security revenues growing 42% and 63% year-on-year respectively.

Video| a key driver for engagement gaining scale

Now, let me explain in more detail our strategy in video, a powerful tool to increase customer engagement and therefore data monetisation.

In Latin America, we are working to migrate TV customers to our IPTV platform with advanced live functionalities, and in parallel, we have launched the OTT service "Movistar Play" in almost all countries, increasing the differentiation and value of our connectivity proposition.

In Spain, video continues to be at the core of our convergent strategy. The premium Movistar + portfolio including exclusive content and the best IPTV platform, results in a superior customer experience which continues to be key in attracting and up-selling customers.

Lastly, in the UK, we have already complemented our existing content offering by launching Netflix as a promotion in June.

I will now hand over to Ángel to explain in more detail segment performance and digitalization.

Ángel Vilá – *Chief Operating Officer*

Digitalization increases customer value and lifespan

Thank you José María,

Let's move now to slide 9 where we show how digitalisation increases customer value and lifespan.

Our growth in strategic assets supported the 3% year-on-year organic growth in Avg. Rev/Access. As clear examples of relatively longer customer lifetimes, it is worth highlighting; 8 years in the UK for mobile contract; 6 years for "Fusión" customers in Spain, 5 and 4 years for mobile contract and fiber customers in Brazil, respectively.

To fully capture the digitalization benefits, we have first built leading smart networks, as the network accounts for more than 50% of total customer satisfaction. We are now focusing on radical automation of processes, with our full stack deployments, being the largest worldwide and the seed of our transformation. These will be the foundations for providing best-in-class digital experience through a digital ecosystem and to provide our customers with a truly distinctive value proposition.

Digital transformation| Easing customer's digital life

Moving to next slide, we show our commitment to digital transformation, in which we are pioneers and are already capturing the impact of customer centric digitalization.

Our customer journey is structured around 5 priorities, which focus on direct sales through digital channels, making payments easier and enhancing service provision and post-sales technical support.

I would like to mention some proof points achieved in our main countries, Spain and Brasil.

In Spain, sales in digital channels increased 45% vs Q2 17 and total users of Movistar App were up by 54%. On the other hand, self-management technical incidents were up 19% in June 2018 vs. December 2017, resulting in 13% reduction of unsatisfied customers with technical support.

At the same time in Brazil, the interactions through digital channels rose by 22% vs. Q2 17, the users of "Meu VIVO" app were up by 66%, prepaid digital top-ups increased by 16%, and e-billing customers rose by 53% year-on-year, and all these translated into a 25% decline of calls to the call center.

Finally, we are progressing well towards our target savings of more than 300 million euros this year, and we have identified other initiatives like RPA (Robotic Process Automation), Cognitive Contact Center and Blockchain, which will also have relevant impacts going forward.

Spain | Good trading; increasing long-term high-value

Moving to slide 11, we present the performance of the domestic business.

We again delivered a solid quarter in terms of commercial trading, with FBB returning to growth (and posting the best quarter in terms of net adds since Q4 2016), and 233k net mobile contract adds, which is 7% accesses growth year-on-year.

We continue to see value increasing within our "Fusión" customer base. Accesses grew 10% year-on-year, whilst ARPU increased 5.5% year-on-year despite the negative tariff' upgrade calendar effect, on an improved value mix thanks to the enhanced portfolio (high-end customers now make for 27% of our total "Fusión" base).

The leading quality and scale of T.España's networks remain unrivalled and they continue to deliver growth in both the retail and wholesale business. In fact, fiber wholesale penetration gains traction in the quarter, with 163k net adds.

Spain | Solid financials; stronger franchise

Moving on to slide 12, we detail how the growth profile of T. España is reflected in its solid profitability and strong financials.

Service revenues annual growth decelerated to +0.1% in the quarter, due to the mentioned negative calendar impact (on "Fusión" tariff upgrades) as well as the loss of wholesale accesses from MásMóvil and MTR cuts (which impact is larger this quarter than in Q1). In any case both residential and business revenues (which altogether account for 83% of service revenues) keep on growing.

Cost discipline and lower commercial costs allowed to more than offset higher content costs. OpEx declined by 0.7 percentage points quarter-on-quarter, leading to a 40.5% OIBDA margin in the quarter.

As regards to football, last month we acquired all Pay-TV rights to broadcast La Liga Football League for seasons 2019-22, and UEFA Champions League and UEFA Europa League for three seasons starting this next September. As a consequence of this, content cost will peak at the end of this year, to start coming down in Q3 19, and remain stable onwards, for the first time in quite a few years.

Germany | Network integration well on-track

Moving to slide 13, Telefónica Deutschland delivered robust operational momentum in the second quarter while successfully progressing with its network integration process. The Company launched a refreshed portfolio of its O_2 Free tariffs, including a popular data "boost" option as well as new O_2 Connect tariffs, further supporting data growth and ARPU-uplift strategy.

In the quarter, the Company benefitted from 333 thousand contract net additions, mainly driven by good take-up of the O_2 Free tariffs and significant partner trading supported by 4G offers. LTE accesses increased by 15% year-over-year to 16.6 million customers, improving LTE penetration to 40 percent and accelerating average data usage by 22 percent quarter-on-quarter to 3.4GB per month.

On financials, MSR ex-regulation continued growing by 0.2% vs the second quarter 2017, and ongoing strong demand for smartphones resulted in handset sales achieving a year-on-year increase of 7.5%. OIBDA registered a year-on-year growth of 0.3% with margin expanding by 0.4 percentage points driven by a focus on profitable growth and efficient cost management.

In the first half, Operating Cash-Flow increased by 3.2% year-on-year, leveraging CapEx and OpEx synergies of a combined ~€90 million.

UK | Ongoing growth delivery across the period

Moving to slide 14,

Telefónica UK posted a good set of second quarter results, again growing financials. The Company remains UK's favourite network carrier with more than 32million customers, and continues to lead market loyalty with the lowest churn. We have successfully deployed our recently won 4G spectrum to enhance connectivity for our customers right away.

The Company delivered another strong quarter being the 7th consecutive quarter of top-line growth. Revenue grew 5.6% year-on-year and MSR ex-regulation accelerated by 3.5%, mainly driven by an increase in customer spend as customers continue to choose us as their preferred mobile operator.

OIBDA grew 8.2% in the quarter and margin expanded by 0.7 percentage points, despite the ongoing regulatory drag, while benefitting from top-line growth and lower Annual Licence Fee payments.

In the first half, Operating Cash Flow ex-spectrum increased by 21.0% year-on-year as a result of these healthy operational trends and phasing of CapEx spend.

Brazil | Reinforcing a leading sustainable business

Let's turn now to slide 15, where we present our Brazilian business, which remains focused on capturing growth in high value markets.

Once again Vivo achieved an outstanding performance in contract, leading the market with a 37% share of new adds thanks to our unrivalled assets, highlighting this quarter the fast 4G+ deployment with 596 new cities covered so far this year.

Contract accesses already account for more than 50% of our mobile customer base, and coupled with the ongoing migration to higher value data offers, mobile ARPU grew by 1% year-on-year.

Fiber reached the highest level of net adds ever, thanks to the continued deployment that already reached 224 cities, 98 of those with FTTH. The higher quality mix of customers led to ARPU and loyalty improvement.

Brazil | Expanding profitability

Turning to slide 16,

We continued to post solid revenue growth thanks to strong and consistent data growth of 12%, and to the accelerated smartphone adoption, boosting handset sales to 60% year-on-year.

The transformation journey continued in fixed revenues with non-traditional services already accounting for 59% of total revenues, driven by our outstanding performance in fiber and IPTV.

OpEx declined for the 10th consecutive quarter thanks to the benefits of digitalization and simplification, and the overall ongoing effort to control costs.

Finally, Vivo's sustainable business allowed to improve profitability, with an upward trend in organic OIBDA margin of 2.2 percentage points to 36.5%.

South Hispam | Solid revenue & OIBDA growth

Let's turn now to slide 17,

South Hispam presented a strong acceleration in contract net adds driven by higher rationality in the region and by the higher differentiation in our offer.

Moreover, fiber connections posted an excellent performance and already represents 46% our total fixed broadband connections base.

This value growth is translated into a solid revenue and OIBDA growth trend in the region, highlighting:

• First, the clear improvement in Chile after posting positive revenue and OIBDA increase for the first time in 10 quarters.

• And second in Peru, the progressive improvement in revenue and OIBDA year-on-year trends.

North Hispam | Mantaining solid commercial performance

On slide 18 we review the commercial performance of the North Region.

We sustained strong commercial traction with positive net adds leveraging on our network quality and against the headwind of the worsening competitive environment in the Mexican market. Let me point out the strong uptake in fiber connections, that almost doubled in just one quarter, driven by Colombia.

Financial trends were highly affected by the new regulation in Mexico since the beginning of 2018. Excluding regulatory effects, revenues and OIBDA would have grown vs. Q2 17 by 1.5% and 5.1%, respectively.

Telxius | Accelerating growth

On slide 19, Telxius showed a solid operational and financial performance, along with increased speed of its infrastructure deployment.

The tower portfolio continued to increase, adding 141 towers in the quarter, mainly in Spain, Brazil and Chile, whilst tenancy ratio reached 1.34x.

In the cable business, the international data traffic improved significantly year-on-year, both in terms of bandwidth capacity (+28%) and IP traffic (+27%).

Regarding financials, top line growth accelerated sequentially, with tower business growing 8.8% year-on-year and cable business significantly improving, while OIBDA increased 4.5%.

CapEx reflected the new cables' deployment, and it is expected to come down during the second half of the year, when BRUSA cable comes into service.

And now, let me hand it over to Laura to explain in detail the financial aspects.

Laura Abasolo – *Chief Financial and Control Officer*

Q2 results factors

Thank you Ángel,

Turning to slide 20, Q2 reported results are affected by non recurrent factors that impact positively OIBDA by 225 million euros, and affect negatively Net Income by -60 million euros. These relate to:

1. The favourable outcome of a Judicial Decision in Brazil increased OIBDA by 485 million euros. This factor has also impacted positively Net Financial Expenses in the quarter and reduced net debt by 855 million euros and is expected to impact FCF progressively in the future.
2. The non-cash goodwill impairment and tax assets reversal in T. México (-108 million euros in OIBDA and -402 million euros in Net Income), following changes in WACC and terminal growth, with a higher risk-free rate reflecting poorer macro conditions.
3. Restructuring costs in Brazil and Germany (-46 million euros in OIBDA) and finally
4. Contingencies in Brazil (-106 million euros in OIBDA), also non-cash.

H1 Net income of €1.7bn and EPS of 0.29€

Moving to slide 21, Net financial expenses, taxes and minorities have also been impacted by these factors.

Net financial expenses mainly reflect the positive impact of the Court Ruling in Brazil, while Taxes are affected by the Mexican impairment and asset reversal, whilst minorities reflect as well the stronger results in T. Brazil.

Despite the negative impact of these factors along with a harsh regulatory drag and adverse FX evolution, net income shows high-single digit year-on-year growth in reported terms and totals €1.7bn in the first half of the year.

FX remains a major drag in Q2 OIBDA year-on-year

Forex continue weighing as slide number 22 shows.

Brazilian Reais and Argentinian peso depreciation vs. the euro are the main contributors to the -445 million euros drag in year-on-year OIBDA variation, higher than the -361 million euros seen in the first quarter. The positive aspect is that organic OIBDA contribution ramped up to 289 million euros in Q2 vs. 214 million euros in the previous quarter.

So, in the first half of the year, the negative FX effect of 817 million euros on OIBDA is reduced to only 158 million euros at the FCF level due to FX reduced CapEx, Taxes, Interest and Minorities. At the net debt level, this reduced the level by 117 million euros on a 3 month rolling basis.

Strong cash generation

On slide 23, we can see that second quarter free cash flow reached almost 1 billion euros, after being impacted by the UK spectrum payment of 0.6 billion euros and negative seasonality. Excluding spectrum FCF grows 54.7% year-on-year and 32.7% in the first half.

In H1, reported FCF surpassed 1.5 billion euros, or 2.2 billion euros ex spectrum.

For the second half of the year, we expect FCF to improve further.

Finally, net financial debt decreased in the second quarter year-on-year for second consecutive year despite dividend payment and the usual H1 seasonality.

Net debt reduction on strong FCF

Let's move now to the financial metrics on slide 24.

We keep on reducing our net debt figure which stands at 43.6 billion euros, as of June, backed by our strong cash flow generation. We have lowered our net debt figure by 637 million euros in the first half of the year.

In terms of our net debt to OIBDA ratio, we ended June at 2.68x which is roughly in line with our 2017 year end.

Strong liquidity thanks to attractive long-term financing

Slide 25 shows how Telefonica has successfully approached capital markets taking advantage of benign market conditions early in the year and raising 11.4 billion euros year to date. Our average debt life remains high at 9 years.

We enjoy a comfortable liquidity position, close to 19 billion euros comfortably exceeding our next two years of maturities.

Effective interest payment costs in the last twelve months stood at 3.48% as of June 2018, 2 basis points below that of March 2018.

I will now hand back to José María.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Concluding remarks| Solid quarterly results

Thank you Laura,

To summarise,

First, we continue to execute on our strategic priorities, focused on our customer-centric transformation.

Second, we continue delivering robust financials and strengthening our balance sheet. As such, we are posting healthy growth rates in Revenues and OIBDA across the board, we continue to accelerate momentum in high value accesses and this the 5th consecutive quarter of net debt reduction.

This allows us to return value to our shareholders, whilst reiterating our 2018 guidance.

Thank you very much for listening and we are now ready to take your questions.

Q&A session

Nicolas Didio - *Berenberg*

I have two questions. First is regarding the expectations in H2 in Spain, regarding the pipeline for your commercial strategy. You have the agreement with Netflix, you are going to launch "Movistar Home", you are going to launch "O2", you're going to have the changes in the Champions League' distribution; I mean the H1 was a decent commercial momentum, shall we expect a clear acceleration of the KPIs let's say in H2 based on that pipeline?

And the second question is regarding Latam. Any potential let's say M&A opportunities to reshuffle the portfolio, asset swaps or any discussions on the network sharing? Thank you.

Angel Vilá – *Chief Operating Officer*

Thank you, Nicolas.

On the question regarding Spain. As you have seen, in the second quarter we have continued with a very positive commercial momentum amid signs of market rationality. We've posted positive net adds across the board in fixed broadband, in fiber, in NEBA fiber, in mobile contract and TV. So, we have seen so far a very positive commercial momentum.

When we look towards the second half, we think that we have a business which if anything is even stronger. We have the best capabilities, we have the best functionalities, we have the best content, so we see that commercial momentum should be strong also in the second half. We would expect "Fusión" positive net adds, we would expect ARPU growth and mobile growth to continue. Fiber take up is growing and expected to continue increasing driving fixed broadband accesses growth, and even in TV, growth is also expected.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Taking your second question

Over the last years we have, as you know, reshaped our portfolio and we have been actively managing our assets. So our focus was always to optimize ROCE and capital allocation and that's why we did the Telxius transaction among others.

And we are constantly reviewing our asset portfolio in order to reinforce our strategic positioning. Our aim is to build leading positions, to have the stronger networks in the market where we operate, while at the same time to increase a clear focus on improving ROCE. So, we are permanently evaluating our assets' return on capital employed, aiming to optimize efficiency and effectiveness of our portfolio.

Our balance sheet has been strengthened, so we don't need to sell any assets at any price, but the fact is that we will review our portfolio when it makes strategic sense. So to conclude, you should expect from us to actively manage our balance sheet to provide us with enough flexibility, and at the same time, to decide over convenience on timing of potential asset disposals, always focusing on improving ROCE.

Mathieu Robilliard - *Barclays*

Good morning. I have two questions please.

First, with regards to your content strategy. So, you've secured the rights for La Liga for a few years. It seems that Vodafone isn't completely committed into buying on a wholesale basis those rights from you. And my question is, couldn't that be actually a positive opportunity for you if you think about the customer pool that's on the competitors' network and that value content, and given the high level of ARPUs? Obviously you would receive less from a wholesale basis but couldn't you make that up with increased market share. So if you could elaborate on that would be helpful.

And then second, with regards to leverage. So obviously, net debt has come down since the beginning of the year, leverage is flat because of Forex as we all know. And I was wondering if you could maybe detail a little bit how you see leverage developing in H2. What are the pluses and minuses? Thank you.

Ángel Vilá – *Chief Operating Officer*

Thank you, Mathieu.

Regarding your question on content in Spain. So far Vodafone has announced that they would not buy the "Partidazo" (the best match of the week) nor the Champion League for the season 2018-19 but Orange has confirmed they will buy both.

You should expect us to be ready to launch to the market compelling commercial offers, including all the football aimed at those potential customers who are now left unsatisfied by their current provider. This tend to be the most valuable, the highest ARPU, the lowest churn customers.

And many of these customers from other players are customers that had explicitly chosen to have football as an add-on to their package with their current or their former providers. So, customers who explicitly wanted and chose to subscribe to football. Those customers will be very welcomed at Movistar TV, and in addition to the football, they will experience a better set of content and functionalities compared with what they have enjoyed up to now.

Mathieu Robilliard- Barclays

If I can follow up. Do you think that could be actually a net positive, this outcome?

Ángel Vilá – *Chief Operating Officer*

Well, in order to quantify the impact we can have in the short-term because of Vodafone not buying the rights from us, you should consider the balance between loss of wholesale revenue and increased retail revenue from an enlarged customer base capturing high value customers.

And here there are many factors which are relevant and which we think are quite strong:

Our Fusion ARPU stands at EUR90, which is significantly more than what others get, and this is because our offer is richer and more complete.

We use football as a tool to upsell and all of our high-value customers have football in their bundles in addition to other benefits, and it's a content that helps to reduce churn.

Owning the content rights, not buying the channel from somebody else, is more valuable because it gives us commercial flexibility to design the content, to label it, to do the wholesale structure and to have additional revenue from advertising.

Penetration of overall Pay TV is still low and football penetration in our base, although it's much higher than other players, still has way to go.

So, we think that when you run the numbers to try and measure the impact of this situation, you should bear in mind all these effects, which all of them would work towards it being positive for us.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Taking your second question on before handing it over to Laura.

You should expect from us to keep taking debt down both organically, and Laura will give you more colour on that, but also inorganically depending on market conditions. So our aim is to keep taking debt down in both fronts.

But I will hand it over to Laura to give you more colour on the organic part.

Laura Abasolo – *Chief Financial and Control Officer*

Yes, thank you, Mathieu for the question.

Let me emphasize again the reduction of the net debt in the first half of the year, which is been down by 10% and it is not only the amount of the debt, is also the management we've done through the first six months of the year.

Increase in the average debt life to 9 years as of June, enlarging the proportion of fixed rates which is now 73%, and which decreased slightly interest payment cost which stands at 3.48%. And this is complemented with a liability management exercise on the higher rates that in the second half of the year will have a slight negative impact in net debt, as you recall, it was a very good exercise that has a payback of around 2.5 years.

I can tell you that Telefonica is definitely committed to maintain a solid investment grade credit rating, and our intention, as José María said, is to continue reducing debt in organic basis. For that we should improve the second part of the year, increasing free cash flow and increasing the quality of free cash flow. We are operating a growing business in terms of revenue, OIBDA and with lower CapEx intensity and that's going to flow through the free cash flow that comfortably exceeds dividend payments, labour commitments and the hybrid coupon payments.

So there's buffer to continue further deleveraging and that could be complemented, as José María also pointed out, with inorganic measures provided that they add value to the Company and they make strategic sense.

Keval Khiroya – *Deutsche Bank*

Thank you. I have got two questions, one on Spain and one on Latam. On the Spanish slides, you do highlight personnel expense as a potential source of further savings. I know it can be a bit difficult to comment on future conditions to leave, should you decide upon it, but do you think we could expect something similar to what we saw at the start of early '17 with the extension of the early retirements program?

And then second on Latam, I think is encouraging that we've now start to see improvements in Chile and Peru, should we expect these improvements in the rates of EBITDA deterioration or EBITDA growth to also continue as well? Thank you.

Ángel Vilá – *Chief Operating Officer*

Thank you, Keval. On the first question, we are seeing incremental savings from the personnel redundancy programs that have already been announced, because these will achieve full run-rate in 2019. Nothing else has been decided so far.

And with respect to the questions in Latam, we have in this quarter the very good news of Chile having turned around after several quarters of decline. The company is back to growth, in revenues and OIBDA. We believe that will be sustainable.

And Peru, as I said in the previous conference call, is progressing in their turnaround process. In the previous quarter they were already in positive commercial activity. This commercial activity has accelerated into the second quarter. The next stage of this turnaround should be moving to growth in revenues, eventually growth in OIBDA which we may see towards the end of this year. So, we see sustainable recovery in Chile and very good trends in Peru.

Georgios Ierodiaconou – *Citi*

Hello. I've got two questions please, both on Spain. My first question is a follow-up, and I appreciate you already partly answered it, around the football content. And I was wondering I know in the run-up to the Fusion, you were running some sensitivity analysis on your customer base. Do you mind just sharing with us some thoughts around how could, let's say one of your competitors use the savings from football to reinvest in other content or discounts, whether this could be a strategy that has some potential success. I'm guessing that's something you looked at that time as well. And also if you could perhaps share with us the importance of the different packages like the Match of the Week and the Champions League versus the other games, whether there is sensitivity in having all the packages or whether there is a significant part of the base happy with the other games?

And then, my second question is around O2. I know it's been just a few weeks over soft launch, but if you could share with us some of your learnings, the traction you're seeing and the way you’ve been dealing with issues earlier in the month. If you could share with us some information on that? Thank you.

Ángel Vilá – *Chief Operating Officer*

Thank you, Georgios. Well, on the first question regarding potential reaction from some competitors that don't have the football, it is not clear to us, it's highly questionable that the subsidy or some retention tools may be an effective way to retain the high ARPU football fans who had explicitly bought an add-on because they wanted to have the best football.

Bear in mind that this will be the first season in the history of Champions League where no free to air game will be broadcasted in Spain. In the previous seasons, half of the matches were broadcasted in free to air, not anymore in Spain.

So, these potential tactical moves from competitors may only result in double self-inflicted damage, putting tension on their commercial costs added to loss of football subscribers anyway.

In any case, we prefer to talk about ourselves. Our strategy will continue to be to grow our business based on value customers.

Regarding the impact of the different matches of the week, obviously the “Partidazo” which is the best match of the week normally played by Barcelona and sometimes by Real Madrid, is a very important piece of content that is critical to have traction with football fans in Spain.

Regarding your question on O2, we have a multi-brand strategy designed to better suit all segments, fulfilling market needs. It's a way to efficiently reach diverse customer profiles and having the objective to strengthen our commercial traction and our financial indicators. We are positioning those brands with differentiated offer propositions through different channels targeting different types of customers with different product components, different communication, following different strategies. So, we do not foresee cannibalization risk.

The launch of O2 has been still on what we call a “beta launch”. The official launch will be in September. O2 complements both our premium brand Movistar and the low cost Tuenti proposals, by filling a commercial space in between, targeting customers that demand a plain but competitive quality proposition, easy product portfolio structure and innovative customer care, what we call “a premium simple” brand, and it will be competitive but rational. The official launch will be in September.

José María Álvarez-Pallete - *Chairman and Chief Executive Officer*

I would like to complement to Ángel that the Champions League has been especially important for Real Madrid supporters last three seasons, and we expect that to continue. Thank you.

Sam McHugh – *Exane BNP Paribas*

So, just on the UK, it looks like the underlying retail business excluding currency and IFRS is perhaps declining around 3% or 4% despite inflationary price increases, but that' has been offset by kind of 50% growth in wholesale. I was just wondering how we should think about the trends in the retail business versus the wholesale business going forward to make us the relative importance of the 2-tier?

And then secondly, in Brazil, we all know what a terrific business Vivo is, they have 43% mobile market share, but you are now underperforming Tim and Claro probably by the widest margin I can remember. So, should we be worried about negative MSR growth at Vivo going forward and what can you do to turn this around? Thanks.

Ángel Vilá – *Chief Operating Officer*

Thank you for your questions. Well, as you've seen our UK business continued to deliver very solid results in the second quarter. We remain to be the leading mobile network carrier with the highest number of subscribers in excess of 32 million, which is a growing base y-o-y and, it's not only growing overall, but our post-paid base is growing 1.2% with growing ARPU and reduced churn. So, we believe that our retail traction in the UK is quite strong and it's proven to be consistent in the last quarters.

Regarding Brazil, we are very focused or extremely focused in contract, in the contract segment, because every contract customer has a lifetime value, which is substantially, very substantially higher than prepaid. So, as far as we continue to get the lion's share of the net adds in contract, we are tolerating a lower traction in prepaid. So, when you look at contract performance, 37% share of net adds in the last months, we have 41.3% market share, we continue to have superior assets, best network, best service and brand recognition… we have had in contract very strong net adds, 9% y-o-y up. Churn has been stabilizing, 51% of our total customer base and 80% of our mobile revenues are in contract. So, we see and we continue to focus in the high value segments in mobile in Brazil, and we feel confident on that.

David Wright – *Bank of America Merrill Lynch*

Very strong set of results. So, José María, when I look at your guidance and I think about H2, you're obviously running ahead on the revenue line, you're very much in line with the margin, but there are indications that operations in H2 could become stronger, Spain in particular. You probably have the toughest comp of O2 UK you have that very tough comp in Q3 last year with roaming, we are seeing some good momentum in the key Latam markets and obviously Germany yesterday was a better number too... Is the guidance starting to look almost a little too conservative now?

And then my second question, just on the net debt. I understand the focus on deleveraging. And Laura, we spent some time on this recently, but is there not an opportunity with the balance sheet very much in shape now with the debt profile very clear, with the cash flows improving, to do some targeted buy-backs, especially given your, I think you'd probably agree, your undervalued share price right now; could there be an opportunity just to do some targeted quite opportunistic moves there? Thank you.

José María Álvarez-Pallete – *Chairman and Chief Executive Officer*

Thanks for your questions. In terms of the guidance: Revenue guidance is to be around 1%. We are at 2% growth in the first half. You know that we are always prudent when we set up our guidance metric and what we can tell you is that current business trends are solid, we are not seeing anything that could significantly alter on the downside what we're seeing today, and we feel confident that we can comfortably meet our guidance. What we can tell you is that we will revisit the issue at the time of the third quarter results, but for the time being, we feel pretty confident, we feel pretty comfortable and you know that we have always been pretty prudent on that part.

In terms of debt evolution and potential share repurchase program, we keep being very focused on debt reduction. What you should expect from us is to focus on free cash flow generation to be devoted to debt reduction, and only when we will be feeling comfortable that we are there, then we will certainly analyse potential share buybacks, because we strongly believe that whatever way you approach it in any metric, but namely on unlevered or levered or equity free cash flow yield, our share price is significantly attractive and that is why we will monitor the best use of our capital in order to improve return on capital employed for our shareholders.

Luis Prota – *Morgan Stanley*

Two questions please. First is again on the football rights and a potential wholesale offer to OTT providers. What I would like to know is, first of all, whether this is a mandatory as it happens to all the telco players as part of your remedies, and secondly how you see this option, whether this is more an opportunity to monetize the football rights or whether there's a higher risk of cannibalization or reducing your competitive position with other peers like Euskaltel, which were offering these through Bein Sports. So I would like your thoughts on how should we look into these whether it would be a positive or a negative and how to address this optionality?

And the second question is on the ownership of the network and more specifically about these comments in the press a few weeks ago on the board exploring a potential sale of the fiber network, anything you can tell us on that would be helpful? Thank you.

Ángel Vilá – *Chief Operating Officer*

Thank you, Luis. On the football wholesale offer to OTTs, we are now in the process of formally getting offers both on Pay TV and OTT for content. These will be due by the end of July. So far what we see is very limited interest on this front. So, we don't see risk of cannibalization.

Jose María Alvarez-Pallete – *Chairman and Chief Executive Officer*

Hi Luis, taking your question on those rumours. We have been hearing the rumours around this potential divestment or contribution of our fiber network in Spain into a fund. We don't know where those rumours are coming from. Our fiber network in Spain is one of our key differential assets. It took us a significant amount of capital and determination to build it. Telefonica España is the European leader in ultra broadband and now, as you know, there is more fiber in the Spain than in the sum of UK, Germany, France, Italy and Portugal together. So, we have no intention to sell it or to contribute it to any fund.

Akhil Datani – *JP Morgan*

I've got two questions both for Spain, please. The first one is just on the competitive environment going forward. And I guess I'm just keen to get your thoughts on two things: one, Vodafone's comment from yesterday, which I'm sure you've heard around the, I guess renewed efforts they're making in the market to turn around the business. I guess we saw a good mobile quarter from them, but still very weak on fixed line and clearly that's where this turn-around is more focused. Are you seeing anything in the market yet?. Is this something you're seeing having much of an impact? And I guess the second bit around that was just Mas Movil launching a low-end TV product. Again, is that relevant at all and is that having any sort of impact. That's the first question.

The second question was just on fiber regulation. We had a couple of years ago the decision by the Spanish regulator to effectively deregulate fiber in competitive areas. Since then the level of fiber deployment in Spain continue to ramp across all players. Could you help us understand if there is any visibility around when the regulator might update that framework. If they did, how much of Spain you think might end up getting deregulated and ultimately where do you think that would have any sort of meaningful impact in terms of how the landscape looks? Thanks a lot.

Ángel Vilá – *Chief Operating Officer*

Hi, Akhil. Thank you for your questions.

On the competitive landscape, what we see is that in 2018 rationality is back. We have seen new “more for more” tariff upgrades applied by all players in the first half. Vodafone, it is true, has been more active in promos in the second quarter, to try to reverse some of their trends, but we see an environment which is rational and constructive. In the mid high-end segment, there are three infra-based players, with rational behaviour, who are oriented to upselling and cross-selling. These are the segments where there is more loyalty; we see tactical promotions, but not structural ones and aiming to be ARPU accretive.

In the low-end, we have seen more intense competition, but now a multi-brand approach is being applied by most players. So, we are getting, and we should be getting more traction on this front.

We believe that we continue to have differential strengths. As Jose María was saying, the best fiber network in Europe, LTE coverage which is second to none, we have the best TV platform in terms of content, functionalities; none of our competitors has a similar level of contents like the one that we have in spite of regulation that makes us to offer premium content to competitors. We think we have the best distribution channels. We are working to have the best digital customer experience. We have the most valuable customer base, the highest ARPU, the longest customer lifetime. So, we feel very well equipped to compete in what we perceive to continue to be a rational market. And all of these, you may say, is "talk", but our results are the clear proof.

Regarding fiber regulation, regulation has a geographical segmentation in Spain. Wholesale price in regulated areas has been determined already: is based on replicability, when it used to be cost-oriented. It means that every retail offer from Telefonica must be replicable with profitability by competitors. The price was set at points higher than the initial expectations and this price allows us to combine generation of wholesale revenues and a competitive retail offer. We signed as you know, wholesale contracts with our main competitors, which are helping to avoid what some people have feared, risk of potential overbuild in fiber in Spain. So, we are getting very good traction both in retail and in wholesale fiber revenues. The prices will be reviewed periodically on a half-year basis and the way the formula goes, "more for more" strategies will be reflected in NEBA prices review. So, if there are tariff upgrades that should result in NEBA price increases.

Jose María Alvarez-Pallete – *Chairman and Chief Executive Officer*

Hi, if I may complement in terms of the competitive zones that you were mentioning; those are 66 cities today and this is reviewed every four years. I think we have one more year and half to go on this before the review. According to our calculations today it's 250 cities that should be included. So, we think that the competitive zone should be significantly expanded in the next regulatory revision.

Akhil Datani – *JP Morgan*

Thanks. That's very helpful. Can I just clarify one point when the regime gets updated in a year-and-a-half, how should we think about what that really means in real terms in terms of the average wholesale rate. I mean did that effectively mean because there's more regions that are deregulated the average wholesale rate rises in those areas for these individuals using a network?

Ángel Vilá – *Chief Operating Officer*

Well, it will provide us with additional commercial flexibility that somehow today is constrained by the regulation, but bear in mind that we have already long-term wholesale agreements in place with Vodafone, with Orange, so that should not have any bad impact.

Jose María Alvarez-Pallete – *Chairman and Chief Executive Officer*

And on the upside, I think that would faster migration from bundling of the local loop access into fiber wholesale market. So that should accelerate the migration into higher speeds and therefore the migration into higher ARPU coming from the wholesale access.

Joshua Mills – *Goldman Sachs*

Sorry to come back to the football rights. But, maybe I can ask in a slightly different way. In the press release which you put out after you confirmed the Mediapro deal, you said that the net costs, i.e. how much you're spending less the wholesale revenues you are hoping to receive of the combined La Liga/UEFA rights, should be 5% higher than compared to the previous cycle. On my numbers, it looks like you're spending about €0.5 billion more on content going forward and clearly if Vodafone decided not to renew the agreement, that's potentially quite a big hole in your Spanish OIBDA next year. My question is: what percentage of Vodafone's 1.3 million TV customers would you need to win given that Orange would also be going after them, so could this be actually a net positive, to put in another analyst's words? And if you do win all those customers, do you also have to assume that there is an ARPU increase given the fees that they're currently paying on the Vodafone network? Thanks.

Ángel Vilá – *Chief Operating Officer*

Thank you, Josh, for the question.

Let me guide you a little bit on the evolution of football content costs in the coming quarters and then I'll get to the Vodafone specific comment.

As you know, we are now entering the third season of the previous La Liga cycle. Here we had only bought as exclusive content the main match of the week, "El Partidazo", which is what is subject to wholesale resale. We didn't buy the remaining matches, we bought the channel from Mediapro, we're not reselling those. So, the impact of resale of content rights in the current season is just restricted to, regarding La Liga, to "El Partidazo" and then, of course, to the Champions League that we have just bought. This means that the football content cost will peak in Q4 this year, will stay the same in Q1 and Q2 of 2019, and will decline from Q3 19 onwards for the following four quarters and then stabilizing. All of these has been factored into our internal projections.

So, for year 2018, we continue to aim to around 40% OIBDA margin, since efficiencies, digitalization benefits and other savings will offset this evolution of content cost. To be clear, starting second half of 2019 there will be deflation in football content costs. This provides high visibility and sustainability to the Spanish business model and the P&L of the Spanish operation for the next 3-4 years, and will allow us to continue to maintain the highest operating cash flow margin of all the European peers.

Regarding Vodafone subscribers, Vodafone claimed to have 400,000 subscribers with football add-ons, not so long ago. Now they say 300,000. I don't know, but maybe there're two possibilities: that they try to minimize the potential erosion of their base or that they are already losing subscribers. In any case, we aim to produce a compelling customer proposition to attract a fair and significant number of the football fans who now may be unsatisfied with their provider.

Mandeep Singh – *Redburn*

Thank you very much. I just wanted to come back to Spanish revenue and OIBDA trends. I mean, I noted that service revenue growth Q2 decelerated versus Q1 just 10 basis points organic growth, so pretty much flat. OIBDA also pretty much flat. Yet you're sort of projecting or painting a much more bullish picture of the Spanish business, which actually is demonstrating no growth. How should we think about the sort of growth outlook for Spain? Is this a business that can actually grow a few percent or this is literally a flat business with flat margins or how should we think about this? Because I don't really see the growth.

Ángel Vilá – *Chief Operating Officer*

Thank you, Mandeep, for the question.

The revenues in the second quarter for the Spanish business went up 0.3%. This was the combination of handset sales, which are having a positive trend on the back of the positive commercial activity that I have spoken about in a previous question, and service revenue trends, which decelerated or reduced the rate of growth compared to the first quarter due to the tariff repositioning calendar. This year we have done some tariff upgrades in the first quarter, last year it was in the second quarter. So, the calendar effect is the one which is affecting the rate of growth.

We do not guide on revenues by regions but, if you look at the trends, you can extrapolate things. So, looking at the different components of service revenues:

B2C, which accounts for 54% of service revenue, is growing in Q2 by 1.0% year-on-year, 72% of this is "Fusión" revenue, growing at 7.7%. So, we have been seeing increases both in volumes and ARPUs with contention or reduction of churn. We may see some promotional activity in the second half in B2C, but, this is a trend that is behaving nicely.

B2B, which accounts for 29% of service revenue, is accelerating growth. It was back to growth already last quarter. It's +1.2% in Q2. And this is a combination of communication revenue services that declined 0.7%, more than compensated by IT revenues, which are growing at 7.4% in Q2. So, the trend and composition of B2B revenues is gradually improving, and we aim for stabilization in B2B for the whole year.

Then, you have "Wholesale and other". "Wholesale and other" this year is declining. The two main factors for this were the loss of MVNO revenue from the Másmóvil owned units, and regulatory impacts due to MTR price cut. This is partially compensated by a growing volume of NEBA wholesale, migrations from copper to fiber wholesale. And content resale dynamics, that we've spoken at length in this call, are also going to be relevant.

So, we do not guide for revenues for the year, but we are reasonably optimistic.

And regarding OIBDA, I already said in a previous question that we see margin levels to remain at around 40% for the year.

Giovanni Montalti – *UBS*

Just a very quick follow-up again on football. You were saying that you expected the decision of Vodafone to have a positive impact on your numbers. Will these be valid also for the short-term, for Q4, for Q3?

Ángel Vilá – *Chief Operating Officer*

As I was commenting before you should expect us to be ready to launch (and now I add the word immediately) to the market compelling commercial offers including all the football aimed at those potential customers who explicitly wanted and chose to subscribe to football with other providers. So I add the word "immediately".

Giovanni Montalti – *UBS*

So, if I may, a very quick follow-up also on the point you're making before about the trend of football cost; you were saying peaking in Q4, and then starting to decline as of H2 or flattening? Because my understanding was that as of H2 19 football cost would be kind of flat for the coming years. Did I understand correctly, you said they will decline?

Ángel Vilá – *Chief Operating Officer*

Let me repeat it. The football content cost will peak in Q4 this year will stay the same in Q1 and Q2 of next year and we'll start declining in Q3 of 2019, also Q4, Q1 and Q2 of 2020 and then it stabilises.

Julio Arciniegas – *RBC*

I understand that the company announced a 5% inflation of net cost of football, assuming that basically will receive wholesale revenues from Orange and Vodafone. So, how this 5% inflation announced by the company is going to change if Vodafone doesn't go? I don't really understand how basically content cost, the net cost is going to be basically lower than is right now?

And my second question is regarding O2. The company said that due to regulation Telefonica wasn't allowed to use a national price of EUR45 and that it was basically forced to use two prices. However, the regulator replied saying that Telefonica can use EUR45 in all the regions and basically that Telefonica just needed to change the wholesale price of FTTH. Has the company considered changing the wholesale price of FTTH to be able to use EUR 45 nationally, and how this will impact also the contracts that you have signed with Orange and Vodafone? Thank you.

Ángel Vilá – *Chief Operating Officer*

Let me try again on the evolution of content cost. Here maybe what you need to bear in mind is the different cycles of three years of one content and the other. So, when we announced the deflation of the cost of La Liga, that's for the season that starts in September 2019 onwards. So, now this coming season, that starts after summer, we are still in the third year of the previous cycle of La Liga which had inflation versus the second year of the previous cycle of La Liga. So, that's why I'm saying that we're going to see content cost increase due to that third season of the previous cycle of La Liga; and we will see the reduction in the cost of La Liga starting in Q3 2019. Obviously, the net cost that we had calculated assuming that Vodafone would be buying those content, at this moment with the current decision of Vodafone (which by the way, if they think twice they are always welcome and able to come back), but with the current decision of Vodafone, the net cost will change and the overall economics for us will depend on the trade-off between that reduced wholesale revenue versus increased retail revenue if we manage to get additional subscribers, which we are reasonably confident.

With respect to O2 prices, we are constrained by the regulation to offer a nationwide offer with the same prices. We want to have a proposition, the EUR45 proposition, we would like to have launched nationwide. Regulation prevents to do it so in regulated areas, and the “customer promise” is that, as soon as there is change in the number of regulated cities and areas, according to the comment that José María made before, we will compensate the customers accordingly. We would have desired or wished to launch that offer from the outset nationwide at a lower price, but unfortunately regulation is not making it possible for us to offer such benefit to our customers.